Speech

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Sweden's economy

Shareholders Association, Sölvesborg-Bromölla

Thank you for the invitation to visit Sölvesborg and the opportunity of talking about Sweden's economy in such a qualified circle of public speakers and in front of an interested and well-informed audience. Considering that the Riksbank's Executive Board will be discussing monetary policy and setting the repo rate next Thursday, I want to take this chance of saying something about my current view of conditions for the decision.

The focal point for our repo rate decisions is an analysis of future inflation in Sweden. Inflationary pressure normally varies over the business cycle. The stronger the growth of production and employment, the greater is the risk of an accelerating increase in prices and wages, and vice versa. In an assessment of the prospects for inflation it is therefore natural to start by discussing cyclical tendencies. But of course it is not only cyclical factors that affect the development of prices. In conclusion I shall also be saying something about such price movements and their place in monetary policy's intellectual framework.

International picture in line with our assessment …

In the Riksbank's most recent Inflation Report we judged that after last year's abrupt slowdown in each of the world's three major economic regions, international activity would gradually recover during 2002.

Bit by bit, demand will respond to the realignment of economic policy that has occurred in the United States and other industrialised countries. The U.S. Federal Reserve has lowered its instrumental rate eleven times since the beginning of last year, by a total of 4.75 percentage points, bringing it down from 6.5 to 1.75 per

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cent. This helping hand from monetary policy is accompanied by fiscal policy's more expansionary direction. Tax cuts and additional public spending have already been approved by Congress and further stimuli may be forthcoming.

Economic policy has also become more expansionary in Europe, where the central bank's instrumental rate has been lowered successively to 3.25 per cent. Fiscal policy, on the other hand, has not been available to the same extent as in the United States. The weak initial state of the public finances has worked against an equally stimulatory line in many countries in Europe, Germany in particular.

The realignment of economic policy, together with signs that stock adjustments are almost over and firms have written off a growing proportion of recent years' misinvestments, points to an economic recovery in the second half of 2002. These were some of the factors behind the forecast the Riksbank presented in December.

So does this assessment still hold? The statistical picture that has emerged since the time of our Inflation Report shows increasingly clear signs, particularly in the United States, that the economic slowdown is levelling off. Tendencies in that direction are also discernible in Europe, though they are not so pronounced.

Of course we cannot be entirely sure and there may be setbacks but it does look as though American consumers have recovered their confidence in the future. U.S. consumption, with a GDP share of around 70 per cent, has been surprisingly robust. Corporate sector productivity is still favourable. Stock adjustments seem to have come a long way. Falling sales when stocks are high usually indicate that firms will be trimming production so that it declines more markedly than demand. In other words, the adjustment of stocks initially has a downward effect on activity. In time, when stocks have been reduced sufficiently, production can be stepped up again even though demand has not yet begun to rise. It is just this positive tendency that should appear soon. For a lasting recovery, however, it needs to be followed by a broader, sustained increase in demand, otherwise it is liable to be relatively brief.

Developments therefore have to be scrutinised closely. There are major imbalances in the American economy and share prices are high, both in a historical perspective and in the present cyclical context. Concern about these problems may be lessened by the high productivity compared with the rest of the world. Household saving relative to disposable income remains exceedingly low. Unemployment is still rising. Against this background there is a risk of the consumption propensity weakening, accompanied by a rising propensity to save, while the recovery of investment is delayed; the combined result would be less chance of a sustained recovery. So an upswing in the American economy is by no means assured. While there are a good many positive signs, there are also risks.

Turning now to Europe, there do not seem to be any clear signs that a recovery is imminent. Still, imbalances such has those in the United States have not accumulated in the euro area. So once a recovery has begun, that will favour its continuation. Leading indicators do admittedly suggest that firms have become more optimistic. But prospects for the German economy – the largest in the euro area – are still uncertain and unemployment is rising.

A recovery in Japan is being thwarted by, among other things, the problems in the financial sector. Prices are falling and so is employment, which contributes to a negative spiral.

So all in all, there is hardly any reason to alter the assessment that an international recovery will occur in the second half of this year. At the same time, there is a risk of it being more sluggish and protracted in the United States, in which case the trend is more likely to be weaker than in the main scenario.

… as is the picture for Sweden

The Riksbank's picture for Sweden in the December Report showed a path that is fairly close to earlier downward and upward phases. Demand is calculated to turn upwards during the second half of this year. This presupposes that household disposable income rises comparatively strongly – by more than 4 per cent this year – partly as a result on lower taxes, increased transfers and a level of employment that remains high despite the economic slowdown. In time, stronger exports in connection with brighter international prospects are expected to stimulate corporate investment. All in all, the GDP growth rate for the Swedish economy is expected to be 1.8 per cent this year and 2.4 per cent in 2003.

Published revisions of the GDP statistics suggest that demand in 2001 may have been somewhat weaker than the Riksbank counted on. This is gainsaid, however, by statistics on retail trade and persistently strong employment. Households are no longer as pessimistic about the future. Moreover, order books have improved and the decline in industrial activity seems to be levelling out and may even have reached a low.

So even the picture we presented of the Swedish economy in the years ahead seems to hold in the main. At the same time there is still some uncertainty, above all as regards international economic activity and the various factors at work there.

The picture of inflation

In December the Riksbank left the repo rate unchanged. The decision rested on the assessment that in the period one to two years ahead inflation would be in line with the 2 per cent target. The currently high rate of inflation was calculated to fall back during the spring of 2002. Weaker economic activity, a stronger exchange rate and lower commodity prices were expected to subdue price developments. Moreover, the price increases for electricity, meat, fruit and vegetables that had stemmed from various supply shocks should drop out of the twelve-month comparisons, leading as it were 'automatically' to lower inflation this spring.

In the balance of risks the Riksbank presented in the December Report, the arguments for lower inflation were that the economic trend might be weaker internationally as well as in Sweden. The upside risks were that inflationary pressure and the impact from a weak exchange rate were underestimated. In the final analysis, these risks were judged to be of equal weight.

New statistics since the Inflation Report was published show that inflation has been somewhat above the calculated rate. From November to December, CPI inflation rose 0.1 percentage point, giving a 12-month rate of 2.9 per cent for December. This is 0.3 percentage points above the Inflation Report's forecast. For underlying inflation as measured by UND1X (the CPI excluding interest expenditure and direct effects of taxes and subsidies), the 12-month rate in December was 3.4 per cent as against the Report's forecast of 3.1 per cent.

The possibility that a part of the increase in inflation, on top of the transitory factors, has to do with the earlier strength of economic activity, cannot be ruled out. When an upswing becomes too rapid, rising business costs may be passed on to consumers, partially or fully, in the form of higher prices. In my opinion, the notion that such an effect on price formation lies behind at least a part of the higher inflation has to be considered. Another factor that may lie behind the increase in inflation is, of course, last year's weak exchange rate.

A substantial deviation, upwards or downwards, from the targeted rate of inflation is always a problem for the central bank. Inflation is currently a good bit above the target and the underlying rate is even outside the upper tolerance limit of 3 per cent. But the situation is somewhat more complicated than that, so I would like to spend some time on a couple of aspects here.

Central banks that operate with an explicit target have to make a choice. In its most extreme form, this amounts to either trying to keep inflation continuously at the targeted rate or accepting deviations that may even last for some time.

Keeping inflation exactly at the targeted rate involves constantly making sizeable repo rate adjustments that lead to abrupt shifts in market rates of interest, output and production. If inflation is allowed to deviate at times from the targeted rate, on the other hand, monetary policy can be conducted more smoothly. Inflation ultimately comes into line with the target as output and production adjust more gradually.

Both of these extreme positions have their pros and cons. Large changes in the repo rate and the attendant marked fluctuations in output and employment can erode people's confidence in the central bank and the monetary policy regime. But excessively wide divergences from the inflation target can weaken its credibility and lead to rising inflation expectations as well as to large costs for ultimately bringing inflation back to the target.

For these reasons, central banks tend to choose a monetary policy strategy that amount to a compromise between these two extremes: avoiding unduly large repo rate adjustments but not hesitating when an adjustment is needed. The Riksbank normally focuses on inflation one to two years ahead but there may be occasions that call for an even longer perspective. A disadvantage here is that the repo rate has to be set on the basis of forecasts and forecasts can be wrong. Price shocks that have little to do with cyclical factors occur all the time and affect the rate of inflation. But a forward-looking policy has the advantage of permitting a direction of monetary policy that is smoother but firm. The Riksbank's reaction to forecast inflation is resolute but as the forecasts include an assessment of the extent to which inflationary impulses are transitory, over-reactions are avoided.

With the monetary policy strategy the Riksbank has chosen, the supply shocks during the past year are examples of price fluctuations that can occasion deviations from the inflation target. They may stem from, for instance, last spring's low water supply for hydroelectric power on account of unusually little snow, a cattle disease that pushes up meat prices, or exceptionally cold weather in Europe that leads to higher prices for fruit and vegetables. If such factors raise the general price level, the rate of inflation will be temporarily increased over the following twelve months. Let me stress that. Transitory effects such as these do not disappear after just a couple of months; instead they continue to show up in the 12-month rate of inflation until they drop out of the statistics a year later.

This is not the first time that transitory factors have affected inflation. For some years in the late 1990s, for example, successive deregulations in electricity and telecom markets caused inflation to deviate from the target, the difference being that the divergence was on the downside. The opposite is the case today. With our monetary policy strategy, that is something we have to live with. The rate of inflation will oscillate around the target. That cannot be emphasised too strongly. Looking back, however, the average rate of inflation since the target was introduced is very close to the target. The intention is that that will continue to be the case in the future.

So it is not the transitory price shocks that are most troublesome as long as they do not affect inflation expectations. Things are different if a deviation has to do with a weak exchange rate or a strong economic upswing. As I just mentioned, both these factors may have something to do with inflation being currently above the target. However, the krona has appreciated and economic activity has slackened. These two tendencies should lead to price pressure being more subdued in the future. That was the Riksbank's appraisal in the latest Inflation Report.

The basic features of this analysis should continue to hold in the future but the Riksbank must follow developments closely to be sure that price increases really do slacken later this spring. With the high outcome to date and the possibility of further price increases for fruit and vegetables, it is conceivable that the downward shift in inflation will occur somewhat later. That employment was maintained last year in spite of the weak production figures is, of course, positive but the reverse of this is a lower increase in productivity. Given the published GDP figures for 2001, the markedly weaker productivity growth has also resulted in pressure from wage costs being higher than expected.

Concluding remarks

To sum up, today I see no grounds for sizeable changes to the real economic assessment the Riksbank presented in December. There are more and more signs of a stabilisation among Sweden's main export countries, something that usually heralds a gradual recovery. Economic activity in Sweden also seems to be levelling out, which likewise tends to result in better cyclical conditions. At the same time, however, there are still some unresolved questions about an international recovery and economic imbalances, not least in the American economy. There are risks here of the type we highlighted in December, risks that still have to be included in the overall assessment.

The picture of inflation broadly holds. The rate of price increases is expected to slacken by degrees. A basic factor here is falling resource utilisation last year and a good way into 2002. Moreover, the upward price effects of occasional factors will cease to apply. Furthermore, a gradual appreciation of the krona would reduce the risk of imported inflation. On the other hand, the relationship in a wide sense between growth and inflation is still a source of uncertainty. So the picture of inflation continues to be a problem that cannot be disregarded. As I see it, the Riksbank must keep a close eye on new inflation statistics, deepen the analysis in the event of deviations and weight this into the ongoing formation of monetary policy.